Alaska Pacific Bancshares, Inc.

2003 ANNUAL REPORT

Contents

Message to Shareholders

It is my pleasure to present the 2003 annual report to shareholders of Alaska Pacific Bancshares, Inc. When we hold our annual meeting in May of this year, we will be just a few weeks away from the fifth anniversary of the formation of Bancshares and the related name change to Alaska Pacific Bank. The bank, which has been serving the market since 1935, continues to be the only operating subsidiary of Alaska Pacific Bancshares, so all remarks are focused on the operations of the bank and its related markets.

The year 2003 was one of growth and change for Alaska Pacific Bank. While the net economic growth of the region was essentially zero, the bank was able to achieve or exceed all of its growth plans for the year. Total assets grew by over $10 million, net loans increased by $18 million and deposits grew by $5.9 million. However, in spite of meeting or exceeding our plan for growth, our earnings were disappointing compared to the previous year. You will immediately note that our recurring income before income tax dropped by 22.1% from $1,185,000 down to $923,000. The decline can be attributed to the reduction in net interest margin, and the increase in noninterest expense related to staff and marketing costs associated with growing the loan portfolio of the bank. Our attention is on the net interest margin, which is feeling the effects of interest rates remaining at record low levels much longer than anticipated. Overall yields have dropped as existing loans reprice in the normal course of doing business, while deposit yields have remained constant at rates that simply can't go any lower. The Management Discussion beginning on page 7 describes in detail the various components giving rise to these changes and I encourage you to read it.

You will also note the introduction of income tax. You may recall that last year we reported a tax benefit of $592,000, which reflected a one-time adjustment to book the value associated with tax credits created from net operating losses in prior years. These losses occurred during the 1980's as a result of the oil-driven recession. This non-recurring component of net income for last year signaled the fact that the bank's performance was strong enough to utilize the remaining tax benefit. We also indicated that income would be treated as "fully taxable" for financial reporting purposes beginning in the first quarter of 2003.

The bank's lending team generated a record volume of loans with total production of nearly $117 million compared to $70 million in 2002. Half of the production was mortgage originations as homeowners continued to refinance, with the other half in commercial real estate, business and consumer loans. Commercial loans accounted for $10 million of the $18 million increase in total loans, which is important for two reasons. First, the commercial loan interest rates are tied to prime and will be able to reprice when rates begin to increase; and second, commercial loans are typically associated other business relationships in the form of commercial deposit accounts, cash management and credit card services.

On the liability side of the balance sheet, we saw deposits grow with a respectable increase of 4.5% to $138.6 million by year-end. More important than the percentage increase was the shift to more noninterest-bearing business deposits and the reduction of interest-bearing time certificates which decreased overall interest expense while increasing noninterest income through service charges.

On the operating side, the bank relocated two retail offices and opened a new mortgage office. In January the Ketchikan Office opened in new quarters after the bank sold the large office building housing the original branch and leased back new, more efficient space. In Sitka, the office moved from its former location into the new corporate headquarters building of Shee Atika, Inc. This new office, which includes a long-awaited drive-up, is a great improvement for both staff and customers.

In September, the bank moved its central mortgage operation into remodeled space adjacent to the headquarters office in Juneau. The department began operating under the name of "Alaska Pacific Mortgage," providing top-level service to both customers and realtors alike. Alaska Pacific Mortgage also moved forward with the launch of "Mortgagebot," which is an Internet-based mortgage loan application system designed for use by customers in the bank, realtors serving customers in their office, or individuals applying for a loan from their home. The product has been operating with a "quiet launch" for testing purposes, but will be unveiled in the spring with the launch of the bank's redesigned website at www.alaskapacificbank.com.

The newly remodeled space in Juneau also provided a new home for the accounting department. Moving both departments was part of the overall plan to take pressure off the Nugget Mall Office headquarters building and minimize the scope of a remodel planned for late in 2004. The building, designed and built more than twenty years ago, needs to provide both customers and employees with workspace that fits the current business model, which has changed significantly over time.

The critical events of the past three years with Worldcom, Arthur Anderson and other companies have brought about significant changes in financial reporting for public companies. The landmark legislation of "Sarbanes-Oxley" as well as other related decisions by the Securities and Exchange Commission, have added to the complexity of our reporting requirements. We understand and respect the need for these changes, and in turn I urge you to take the time to read this report in its entirety. The "Management's Discussion and Analysis of Financial Condition and Results of Operations," in addition to the financial statements and footnotes, provides a thorough discussion of each financial component and is intended to make help you, the shareholder, understand our business.

In the final analysis, we are mindful of the earnings of the bank, but are still very pleased with the progress the bank is making relative to its business plan and our position in the market. Our growth has been earned with the reputation of a very professional and dedicated team of officers and employees who are committed to serving this very unique market. They perform their jobs with integrity and pride in what has been and what will be accomplished.

So, on behalf of the board of directors, officers and employees, I thank you for your confidence in our company. We remain clear on our responsibilities to you, the shareholder.

Respectfully,

Craig E. Dahl
President and Chief Executive Officer

Business of the Company

Alaska Pacific Bancshares, Inc. (the "Company") was organized on March 19, 1999 for the purpose of becoming the holding company for Alaska Pacific Bank (formerly Alaska Federal Savings Bank) (the "Bank"), upon its conversion from a federal mutual savings bank to a federal stock savings bank. The conversion was completed on July 1, 1999 with the issuance of 655,415 shares of common stock at $10.00 per share. The Company is not engaged in any significant business activity other than holding the stock of the Bank. Accordingly, the information in this report, including the consolidated financial statements and related data, applies primarily to the Bank.

The Bank is a federal stock savings bank originally organized in 1935. The Bank is regulated by the Office of Thrift Supervision ("OTS"), and its deposits are insured up to applicable limits by the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). The Bank has been a member of the Federal Home Loan Bank System since 1937.

The Bank operates as a community-oriented financial institution and is devoted to serving the needs of its customers, primarily in Southeast Alaska. The Bank's business consists primarily of attracting deposits from the general public and using those funds to originate residential real estate loans, commercial real estate loans, commercial business loans, and a variety of consumer loans.

Common Stock Information

The Company's common stock is traded on the over-the-counter market through the OTC "Electronic Bulletin Board" under the symbol "AKPB." As of December 31, 2003, there were approximately 500 stockholders of record and 626,132 shares outstanding (including 23,252 unearned Employee Stock Ownership Plan ("ESOP") shares and 8,300 unvested shares issued as restricted stock awards). Generally, if the Bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed in the OTS regulations. However, institutions that have converted to the stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the Bank's mutual-to-stock conversion.

The following table sets forth market price information of the Company's stock for 2002 and 2003.

	Market Price		
Years Ended December 31,	High	Low	Dividends
2002:			
First Quarter	$13.20	$10.60	$0.05
Second Quarter	16.10	12.50	0.06
Third Quarter	15.25	14.40	0.06
Fourth Quarter	17.14	14.50	0.06
2003:			
First Quarter	19.75	16.50	0.06
Second Quarter	20.00	18.10	0.07
Third Quarter	21.00	18.80	0.07
Fourth Quarter	20.65	19.65	0.07

Selected Consolidated Financial Information

This information should be read in conjunction with the Consolidated Financial Statements and related Notes thereto included elsewhere in this report. Per-share information is not presented for the year ended December 31, 1999, as it began prior to the Company's initial public offering on July 1, 1999.

Financial Condition Data:

(in thousands) December 31,	2003	2002	2001	2000	1999
Total assets	$164,559	$154,339	$154,572	$135,465	$121,542
Loans, net	124,123	106,122	110,253	104,836	85,796
Loans held for sale	2,938	4,590	995	735	1,359
Investment securities available for sale	11,292	8,076	12,351	16,257	19,849
Cash, due from banks, and interest-earning deposits in banks	19,126	28,229	23,886	6,847	7,785
Deposits	138,612	132,681	126,309	107,989	102,547
Federal Home Loan Bank advances	9,219	5,000	13,000	13,400	5,000
Shareholders' equity	15,257	14,967	12,991	12,383	12,477

Operating Data:

(in thousands) Year ended December 31,	2003	2002	2001	2000	1999
Interest income	$8,628	$9,315	$10,582	$9,843	$8,477
Interest expense	1,921	2,453	4,441	4,398	3,669
Net interest income	6,707	6,862	6,141	5,445	4,808
Provision for loan losses	195	370	210	395	15
Net interest income after provision for loan losses	6,512	6,492	5,931	5,050	4,793
Noninterest income	1,388	1,272	1,212	813	713
Noninterest expense	7,062	6,579	6,683	5,744	5,235
Income before income tax	838	1,185	460	119	271
Provision for income tax (benefit)	335	(592)	-	-	-
Net income	$ 503	$1,777	$ 460	$ 119	$ 271
Net income per share:					
Basic	$0.86	$3.10	$0.82	$0.20	-
Diluted	0.81	2.98	0.80	0.20	-

Other Data:

December 31,	2003	2002	2001	2000	1999
Number of:					
Real estate loans outstanding	842	854	924	896	824
Deposit accounts	12,842	13,369	13,735	13,434	12,436
Full service offices	7	7	7	9	7

Key Financial Ratios:

At and for Year ended December 31,	2003	2002	2001	2000	1999
Performance ratios:					
Return on average assets	0.32%	1.21%	0.32%	0.09%	0.23%
Return on average equity	3.34	12.93	3.63	0.96	2.68
Interest rate spread (1)	4.25	4.66	4.04	4.18	4.11
Net interest margin:					
On average earning assets	4.50	4.97	4.51	4.63	4.44
On average total assets	4.20	4.66	4.23	4.32	4.09
Average interest-earning assets to average interest-bearing liabilities	120.05	117.50	114.49	112.08	109.83
Noninterest expense as a percent of average total assets	4.42	4.47	4.60	4.55	4.45
Efficiency ratio (2)	91.11	84.29	95.73	93.50	95.70
Asset Quality Ratios:					
Nonaccrual loans as a percent of net loans	0.25	1.67	1.23	0.79	0.08
Nonperforming assets as a percent of total assets	0.37	1.27	0.99	0.69	0.18
Allowance for losses as a percent of total loans	0.93	1.07	0.84	0.75	0.66
Allowance for losses as a percent of nonperforming loans	370.29	64.83	69.09	94.60	814.29
Net chargeoffs to average loans	0.17	0.14	0.05	0.18	0.14
Equity Ratios:					
Total equity to assets	9.27	9.70	8.40	9.14	10.27
Average equity to average assets	9.42	9.34	8.73	9.81	8.59

(1) Difference between weighted average yield on interest-earning assets and weighted average rate on interest-bearing liabilities

(2) Noninterest expense as a percent of the sum of net interest income and noninterest income, excluding gains on sale of loans and investments.

Management's Discussion and Analysis of Financial Condition and Results of Operations

General

The following discussion is intended to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is not engaged in any significant business activity other than holding the stock of the Bank. Accordingly, the information in this discussion applies primarily to the Bank. The information contained in this section should be read in conjunction with the consolidated financial statements and the accompanying notes elsewhere in this annual report. In the following discussion, except as otherwise noted, references to "2003" or "2002" indicate the year ended December 31, 2003 or 2002.

The Bank's results of operations depend primarily on its net interest income, which is the difference between the income earned on its interest-earning assets, consisting of loans and investments, and the cost of its interest-bearing liabilities, consisting of deposits and Federal Home Loan Bank ("FHLB") borrowings. Among other things, fee income, provisions for loan losses, operating expenses and income tax provisions also affect the Bank's net income. General economic and competitive conditions, particularly changes in market interest rates, government legislation and policies concerning monetary and fiscal affairs, housing and financial institutions and the attendant actions of the regulatory authorities also significantly affect the Bank's results of operations.

Forward-Looking Statements

This annual report contains forward-looking statements which are based on assumptions and describe future plans, strategies and expectations of the Company. These forward-looking statements are generally identified by use of the word "believe," "expect," "intend," "anticipate," "estimate," "project," or similar words. The Company's ability to predict results or the actual effect of future plans or strategies is uncertain. Factors which could have a material adverse effect on our operations include, but are not limited to, changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market areas, and accounting principles and guidelines. You should consider these risks and uncertainties in evaluating forward-looking statements and you should not rely too much on these statements.

Operating Strategy

The Company's strategy is to operate a community-oriented financial institution devoted to serving the needs of its customers. The Company's business consists primarily of attracting retail deposits from the general public and using those funds to originate residential real estate loans, commercial real estate loans, commercial business loans, and a variety of consumer loans.

Financial Condition

Total assets increased 6.7% to $164.6 million at December 31, 2003 from $154.3 million at December 31, 2002, primarily due to growth in loans and investments, partially offset by a decrease in cash and cash equivalents.

Loans increased $18.0 million, or 16.8%, to $125.3 million at December 31, 2003 from $107.3 million at December 31, 2002. Loan demand continued to be strong in 2003, as loans originated and purchased increased 66.9% to $116.8 million from $70.0 million originated in 2002.

Following is a comparison of the composition of the portfolio at both dates:

(dollars in thousands) December 31,	2003		2002	
	Amount	Percent	Amount	Percent
Real estate:				
Permanent:				
One- to four-family	$46,219	36.89%	$41,419	38.60%
Multifamily	1,108	0.88	2,209	2.06
Commercial nonresidential	34,222	27.32	26,075	24.31
Land	3,425	2.73	5,120	4.77
Construction:				
One- to four-family	2,330	1.86	3,643	3.40
Commercial nonresidential	-	-	52	0.05
Commercial business	23,050	18.40	12,975	12.10
Consumer:				
Home equity	9,361	7.47	8,912	8.31
Boat	4,326	3.45	5,249	4.89
Automobile	642	0.51	831	0.77
Other	599	0.48	789	0.74
Total loans	125,282	100.00%	107,274	100.00%
Less:				
Allowance for loan losses	1,159		1,152	
Loans, net	$124,123		$106,122	

Commercial business loans increased $10.1 million, or 78%, during 2003. Continuing efforts to bring in small business customers resulted in strong loan demand. Business loan originations in 2003 increased ten-fold to $26.8 million from $2.5 million in 2002, but included many refinanced loans.

New mortgage loan originations of $48.7 million outpaced prepayments, but $29.8 million, or 61.2%, of these mortgages were sold in the secondary market. The result was that one- to four-family mortgage loans increased a net of $4.8 million to $46.2 million at the end of 2003.

Cash and cash equivalents decreased $9.1 million to $19.1 million at December 31, 2003, compared to $28.2 million at December 31, 2002. The decrease was primarily the result of the $21.2 million increase in loans and investments, partly offset by increases in deposits and FHLB advances. Balances in excess of current needs are intended to be used primarily to fund growth in loans and investment securities in 2004.

Available-for-sale securities increased $3.2 million to $11.3 million at December 31, 2003, compared to $8.1 million at December 31, 2002. The increase was the result of a purchase of approximately $10 million of mortgage-backed securities in January 2003, offset by continuing reductions in principal due to rapid prepayments in the underlying loans.

Premises and equipment at December 31, 2003 was $2.1 million, a decrease of $1.0 million from December 31, 2002. The decrease was primarily the result of the sale of the Bank's building in Ketchikan, Alaska for $1.4 million in February 2003. The Bank is leasing back a portion of the building at market rental rates for continued use as a banking office.

Total deposits increased $5.9 million, or 4.4%, to $138.6 million at December 31, 2003 from $132.7 million at December 31, 2002. With the exception of certificates of deposits, balances increased in all deposit categories primarily as a result of marketing efforts aimed at increasing deposits from business customers. Certificates of deposit declined $1.6 million, or 4.1%, primarily due to less aggressive pricing in this type of deposit.

FHLB advances increased to $9.2 million at December 31, 2003 from $5.0 million at December 31, 2002 due to the addition of $5.0 million of three- and five-year fixed-rate amortizing advances in connection with the purchase of fixed-rate mortgage backed securities.

Results of Operations

Net Income. Net income decreased by $1.3 million to $503,000 for 2003, compared with $1.8 million for 2002. Net income for the two years is not directly comparable, primarily due to the income tax provision. While 2003 net income was net of a normal tax provision of $335,000, the provision for 2002 was a net income tax benefit of $592,000, providing a decrease to net income of $927,000. See “Income Tax” elsewhere in this discussion. In addition, 2003 income included a loss of $85,000 related to the sale of the Bank’s office building in Ketchikan.

Income before income tax, excluding the loss on sale of building, was $923,000 in 2003, a decrease of $262,000, or 22.1%, from $1,185,000 in 2002. The decrease is due primarily to increased expenses and decreased net interest income, offset by increased noninterest income and a reduced provision for loan losses. For purposes of comparison, pre-tax income may be separated into major components as follows:

(in thousands) Year ended December 31,	2003	2002	Income Increase (Decrease)
Net interest income	$6,707	$6,862	$(155)
Gain on sale of mortgage loans	344	329	15
Other noninterest income	1,044	943	101
Net revenues	8,095	8,134	(39)
Noninterest expense, excluding loss on sale of building	(6,977)	(6,579)	(398)
Subtotal	1,118	1,555	(437)
Provision for loan losses	(195)	(370)	175
Pre-tax income, excluding branch closure costs	923	1,185	(262)
Loss on sale of building	(85)	-	(85)
Income before income tax	$ 838	$1,185	$(347)

Net Interest Income. Net interest income decreased $155,000, or 2.3%, to $6.7 million in 2003 from $6.9 million in 2002. The decline is due to a combination of factors. See the table in “Average Balances, Interest and Average Yields/Cost” elsewhere in this discussion.

While average earning assets grew by $10.8 million, loan prepayments and the sale of a portion of new loan production contributed to a $4.7 million decline in average loans in 2003 compared with 2002. Combined with an increase in funds from growth in deposits, this resulted in a shift in earning assets from loans to relatively lower-yielding cash equivalents and investments. In the declining interest-rate environment, the average yield on loans declined 40 basis points (“bp”) to 6.98% in 2003 from 7.38% in 2002 but, because of the shift in asset mix, the overall yield on earning assets declined 96 bp to 5.79% from 6.75%.

Total interest expense decreased $532,000, or 21.7%, to $1.9 million in 2003 from $2.5 million in 2002. The decrease is attributable not only to lower market interest rates, but also to a gradual shift away from relatively high-cost certificates of deposit to relatively low-cost demand and savings deposits. Following is a comparison of the composition of average deposits and borrowings for 2003 and 2002:

(dollars in thousands) Year ended December 31,	2003		2002	
Average daily balance of:				
Noninterest-bearing demand deposits	$18,130	12.8%	$14,346	10.9%
Interest-bearing demand deposits	30,569	21.5	29,123	22.1
Money market accounts	23,238	16.3	21,630	16.4
Savings accounts	23,048	16.2	21,134	16.0
Certificates of deposit	37,725	26.5	40,126	30.4
FHLB advances	9,457	6.7	5,485	4.2
Total average deposits and borrowings	$142,167	100.0%	$131,844	100.0%

Although average interest rates declined in 2003 compared with 2002 on both sides of the balance sheet, the decline was relatively greater for assets. Thus, the overall average cost on interest-bearing liabilities decreased to 1.55% in 2003 from 2.09% in 2002, a decrease of 54 bp compared with the 96 bp decline in the yield on average earning assets. This disparity is attributable not only to the change in asset mix but also to market competition for both loans and deposits, especially when the Bank is seriously competing for new business. This effect, sometimes called an interest-rate “squeeze,” was more pronounced in the fourth quarter of 2003, and is expected to continue into at least a portion of 2004.

Noninterest Income. Total noninterest income increased $116,000, or 9.1%, to $1.4 million in 2003, compared with $1.3 million in 2002.

Gains on sale of mortgage loans increased $15,000, or 4.6%, to $344,000 in 2003 from $329,000 in 2002. Such gains are a part of the Bank’s core business, but tend to be more variable than other components of noninterest income due to (1) changes in market interest rates which greatly affect the level of mortgage refinancing activity and (2) management’s ongoing decisions on what portion of the mortgage loan production is sold or kept in the loan portfolio. Generally the “keep or sell” decisions are made for purposes of asset and liability management, including managing interest-rate risk. Due to lower mortgage interest rates and increased refinance activity, the volume of gains was relatively high in both 2003 and 2002.

Excluding gains on sale of mortgage loans, noninterest income increased $101,000, or 10.7%, to $1,044,000 in 2003 compared with $943,000 in 2002. The largest contributor to this increase was service charges on deposit accounts, which increased $98,000, or 17.4%. The increase in service charge income is primarily attributable to continued growth in deposits, particularly checking accounts.

Noninterest Expense. Noninterest expense, excluding the $85,000 loss on the sale of the Ketchikan office building, increased $398,000, or 6.0%, to $7.0 million in 2003 from $6.6 million in 2002. In addition to normal cost increases, the increase reflects management’s emphasis on investing in sales and support staff and in marketing efforts to enable greater penetration into the small business and consumer markets. As a result, compensation and benefits expense increased 8.9% to $3.7 million in 2003 from $3.4 million in 2002. Marketing and public relations expense increased 24.9% to $226,000 in 2003 from $181,000 in 2002.

Income Tax. For several years prior to 2002, the Company did not recognize any tax on current income because of the existence of tax net operating loss carryforwards ("NOLs"). During this period, net deferred tax assets in the balance sheet (resulting from the NOLs and other temporary differences between accounting income and taxable income) were substantially decreased through a valuation allowance because full realization was dependent upon earning sufficient taxable income prior to the expiration of the NOLs, and the Company's income levels did not support a conclusion that their realization within the expiration periods was likely. Thus, the tax benefit was recognized only to the extent of each year's taxable income, resulting in a net provision for income tax of zero for each of those years.

In 2002, however, the Company recognized the deferred tax benefits not only to the extent of current-year income but also the benefit of the remaining deferred tax assets at December 31, 2002, amounting to $592,000. Management believes that it is more likely than not that future earnings will result in full realization of these tax benefits. Beginning with 2003, net income now reflects a "normal" provision for federal and state income taxes amounting to approximately 40% of taxable income.

Provision and Allowance for Loan Losses

Provisions for loan losses are charges to earnings to bring the total allowance for loan losses to a level considered by management to be adequate to provide for known and inherent risks in the loan portfolio, including management's continuing analysis of factors underlying the quality of the loan portfolio.

The provision for loan losses decreased to $195,000 for 2003 compared to $370,000 for 2002. The provisions for both years were considered appropriate in order for the allowance for loan losses to reflect management's best estimate of losses inherent in the loan portfolio. The allowance for loan losses was approximately unchanged at $1.2 million at December 31, 2003 and 2002, but decreased as a percentage of loans to 0.93% at the end of 2003 from 1.07% at the end of 2002. The provisions and the resulting allowance are reflective of numerous factors, including the following:

- **Loan losses.** Net loan chargeoffs were $188,000 (0.15% of total loans) in 2003 compared with $157,000 (0.15% of total loans) in 2002.
- **Growth and composition of the portfolio.** Total loans increased to $125.3 million at December 31, 2003, compared with $107.3 million at December 31, 2002. This net increase, however, reflects wider changes in composition away from single-family mortgages, which declined to 36.9% of the portfolio from 38.6%, moving to a greater proportion of loans to businesses, especially commercial business loans, which increased to 18.4% of the portfolio at December 31, 2003 from 12.1% at December 31, 2002. Management considered the higher relative risk of these loans in assessing the adequacy of the allowance.
- **Management analysis of potential problem loans.** As part of an assessment of the adequacy of the allowance, management performed a detailed review of individual loans for which full collectibility may not be assured. Significantly, such loans decreased to $1.0 million (0.8% of total loans) at December 31, 2003, compared with $2.9 million (2.7% of total loans) at December 31, 2002. Of these, estimated loan impairments of approximately $136,000 and $329,000 were specifically considered in the assessment at December 31, 2003 and 2002, respectively.

- **Nonperforming and classified loans.** Nonaccrual loans decreased to $313,000 (0.2% of total loans) at December 31, 2003, from $1.78 million (1.7% of total loans) at December 31, 2002. Loans classified as "substandard" or "doubtful" decreased to $378,000 (0.3% of total loans) at December 31, 2003, from $1.8 million (1.7% of total loans) at December 31, 2002.
- **Economic conditions.** Management considered known economic conditions in each of the geographic areas that the Bank makes loans. For the last several years, Southeast Alaska's economy has been relatively "flat" but stable, and management knows of no current economic conditions that warrant expectations of significant growth or decline in the Bank's markets. However, uncertainties in both the national and local economies have been considered in assessing the allowance.

The Company's accounting for the allowance for loan losses is its most critical accounting process and is also the most subjective. While management believes that it uses the best information available to determine the allowance for loan losses, unforeseen market conditions and other events might result in adjustment to the allowance if circumstances differ substantially from the assumptions used in making the final determination. One or more of these events could have a significant effect on net income, and the effect could be both material and adverse.

For further information on the Bank's accounting for the allowance for loan losses as well as how loan impairment is determined, see Note 1 of Notes to Consolidated Financial Statements.

Average Balances, Interest and Average Yields/Cost

The earnings of the Company depend largely on the spread between the yield on interest-earning assets, which consist primarily of loans and investments, and the cost of interest-bearing liabilities, which consist primarily of deposit accounts and borrowings, as well as the relative size of the Company's interest-earning assets and interest-bearing liabilities.

The following table sets forth, for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resultant yields, interest rate spread, net interest margin, and ratio of average interest-earning assets to average interest-bearing liabilities. Average balances are generally daily averages for the period.

(dollars in thousands) Year ended December 31,	2003			2002		
	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
Interest-earning assets:						
Loans [1]	$110,125	$7,684	6.98%	$114,864	$8,477	7.38%
Investment securities [1]	16,383	712	4.35	12,021	667	5.55
Interest-earning deposits in banks	22,398	232	1.04	11,181	171	1.53
Total interest-earning assets	148,906	8,628	5.79	138,066	9,315	6.75
Allowance for loan losses	(1,172)			(1,052)		
Cash and due from banks	5,732			5,420		
Other assets	6,140			4,832		
Total assets	$159,606			$147,266		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	$30,569	$143	0.47%	$ 29,123	$ 227	0.78%
Money market	23,238	241	1.04	21,630	359	1.66
Savings	23,048	181	0.79	21,134	309	1.46
Certificates of deposit	37,725	900	2.39	40,126	1,220	3.04
Total interest-bearing deposits	114,580	1,465	1.28	112,013	2,115	1.89
Borrowings	9,457	456	4.82	5,485	338	6.16
Total interest-bearing liabilities	124,037	1,921	1.55	117,498	2,453	2.09
Noninterest-bearing demand deposits	18,130			14,346		
Other liabilities	1,247			1,674		
Shareholders' equity	15,039			13,748		
Total liabilities and shareholders' equity	$159,606			$147,266		
Net interest income		$6,707			$6,862	
Interest rate spread			4.25%			4.66%
Net interest margin:						
On average interest-earning assets			4.50%			4.97%
On average total assets			4.20			4.66
Ratio of average interest-earning assets to average interest-bearing liabilities	120.05%			117.50%		

[1] Average loans include nonperforming loans and loans held for sale. Interest income does not include interest on nonaccrual loans. Average investment securities includes FHLB stock.

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on net interest income of the Company. Information is provided with respect to effects on interest income attributable to changes in volume, which are changes in volume multiplied by prior rate; effects on interest income attributable to changes in rate, which are changes in rate multiplied by prior volume; and changes in rate/volume, which is a change in rate multiplied by change in volume.

(in thousands) Year ended December 31, 2003 compared with 2002	Rate	Volume	Rate/ Volume	Total
Interest-earning assets:				
Loans	$(462)	$ (350)	$ 19	$(793)
Investment securities	(145)	242	(52)	45
Interest-earning deposits in banks	(55)	172	(56)	61
Total net change in interest income	(662)	64	(89)	(687)
Interest-bearing liabilities:				
Interest-bearing demand accounts	(91)	11	(4)	(84)
Money market accounts	(135)	27	(10)	(118)
Savings accounts	(143)	28	(13)	(128)
Certificates of deposit	(263)	(73)	16	(320)
Borrowings	(74)	245	(53)	118
Total net change in interest expense	(706)	238	(64)	(532)
Net change in net interest income	$ 44	$(174)	$(25)	$(155)

Yields Earned and Rates Paid

The following table sets forth, at the date and for the periods indicated, the weighted average yields earned on the Company's assets and the weighted average interest rates paid on the Company's liabilities, together with the net yield on interest-earning assets.

	At December 31,	For the Year Ended December 31,	
	2003	2003	2002
Weighted average yield on:			
Loans	6.14%	6.98%	7.38%
Investment securities	4.40	4.35	5.55
Interest-earning deposits in banks	0.84	1.04	1.53
Total interest-earning assets	5.56	5.79	6.75
Weighted average rate paid on:			
Interest-bearing demand accounts	0.25	0.47	0.78
Money market accounts	0.81	1.04	1.66
Savings accounts	0.55	0.79	1.46
Certificates of deposit	2.12	2.39	3.04
Total interest-bearing deposits	1.01	1.28	1.89
Borrowings	4.82	4.82	6.16
Total interest-bearing liabilities	1.28	1.55	2.09
Interest rate spread	4.48	4.25	4.66
Net interest margin on:			
Average interest-earning assets	4.48	4.50	4.97
Average total assets	4.15	4.20	4.66

Asset and Liability Management and Market Risk

Qualitative Analysis - Risks When Interest Rates Change. The Bank's profitability depends primarily on its net interest income, which is the difference between the income it receives on its loan and investment portfolios and its cost of funds, which consists of interest paid on deposits and borrowings. The relative amounts of interest-earning assets and interest-bearing liabilities also affect net interest income. When interest-earning assets equal or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income. The Bank's profitability is also affected by the level of noninterest income and expenses. Noninterest income includes service charges and fees and gain on sale of loans and investments. Noninterest expenses primarily include compensation and benefits, occupancy and equipment expenses, deposit insurance premiums and data processing expenses. General economic and competitive conditions, particularly changes in market interest rates, government legislation and regulation, and monetary and fiscal policies also significantly affect the Bank's results of operations.

Quantitative Analysis - How the Bank Measures Its Risk of Interest Rate Changes. The Bank does not maintain a trading account for any class of financial instrument nor does it engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Bank has no significant foreign currency exchange rate risk or commodity price risk.

The Bank has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. Principal elements in achieving this objective include increasing the interest-rate sensitivity of the Bank's interest-earning assets by originating for its portfolio loans with interest rates that periodically adjust to market conditions, as well as continuing decisions to sell fixed-rate mortgage production versus keeping them in the portfolio. The Bank relies on retail deposits as its primary source of funds. Management believes retail deposits, compared to brokered deposits, reduce the effects of interest rate fluctuations because they generally represent a more stable source of funds.

In order to encourage institutions to reduce interest rate risk, the OTS adopted a rule incorporating an interest rate risk component into the risk-based capital rules. Using data compiled by the OTS, the Bank receives a report that measures interest rate risk by modeling the change in net portfolio value over a variety of interest rate scenarios. The OTS developed this procedure for measuring interest rate risk to replace the "gap" analysis, which is the difference between interest-earning assets and interest-bearing liabilities that mature or reprice within a specific time period. Net portfolio value is the present value of expected cash flows from assets, liabilities and off-balance-sheet contracts. The calculation is intended to illustrate the change in net portfolio value that will occur upon an immediate change in interest rates of at least 200 basis points with no effect given to any steps that management might take to counter the effect of that interest rate movement. Under OTS regulations, an institution with a greater than "normal" level of interest rate risk takes a deduction from total capital for purposes of calculating its risk-based capital. The OTS, however, has delayed the implementation of this regulation. An institution with a "normal" level of interest rate risk is defined as one whose "measured interest rate risk" is less than 2.0%. Institutions with assets of less than $300 million and a risk-based capital ratio of more than 12.0% are exempt. The Bank is exempt because of its asset size and risk-based capital ratio. Based on the Bank's regulatory capital levels at December 31, 2003, the Bank believes that, if the proposed regulation had been implemented at that date, the Bank's level of interest rate risk would not have caused it to be treated as an institution with greater than "normal" interest rate risk.

The following table illustrates the change in net portfolio value at December 31, 2003, based on OTS assumptions, that would occur in the event of an immediate change in interest rates, with no effect given to any steps which management might take to counter the effect of that interest rate movement.

(dollars in thousands)	Net Portfolio Value			Net Portfolio as % of Portfolio Value of Assets	
Basis Point ("bp") Change in Rates	Dollar Amount	Dollar Change [(1)]	Percent Change	Net Portfolio Value Ratio [(2)]	Change [(3)]
300 bp	$18,764	$(1,925)	(9)%	11.28%	(88) bp
200	19,661	(1,029)	(5)	11.72	(45)
100	20,451	(239)	(1)	12.09	(8)
0	20,690	-	-	12.17	-
(100)	20,127	(563)	(3)	11.83	(34)

(1) Represents the increase (decrease) of the estimated net portfolio value at the indicated change in interest rates compared to the net portfolio value assuming no change in interest rates.

(2) Calculated as the estimated net portfolio value divided by the portfolio value of total assets.

(3) Calculated as the increase (decrease) of the net portfolio value ratio assuming the indicated change in interest rates over the estimated net portfolio value ratio assuming no change in interest rates.

The above table illustrates, for example, that at December 31, 2003 an instantaneous 200 basis point increase in market interest rates would reduce the Bank's net portfolio value by $1,029,000, or 5%, and an instantaneous 100 basis point decrease in market interest rates would reduce the Bank's net portfolio value by $563,000, or 3%.

The following summarizes key exposure measures for the dates indicated. They measure the change in net portfolio value ratio for an adverse change in interest rates of 200 basis points upward or 100 basis points downward.

	December 31, 2003	September 30, 2003	December 31, 2002
Pre-shock net portfolio value ratio	12.17%	12.08%	13.57%
Post-shock net portfolio value ratio	11.72%	11.47%	13.07%
Decline in net portfolio value ratio	45 bp	61 bp	51 bp

The calculated risk exposure measures indicate that the Bank's interest-rate risk at December 31, 2003 has decreased from the previous year end, in that a "shock" increase or decrease in market rates would have a relatively smaller negative effect on net portfolio value. These measures indicate a relatively low level of interest-rate risk at the present time. Among other factors, this is due to a decrease in fixed-rate mortgages and a gradual shift to earning assets that tend to reprice with greater frequency.

The OTS uses certain assumptions in assessing the interest rate risk of thrift institutions. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates, and the market values of certain assets under differing interest rate scenarios, among others. As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the table.

Liquidity and Capital Resources

The Bank's primary sources of funds are deposits, proceeds from principal and interest payments on loans and mortgage-backed securities, and FHLB advances. While maturities and scheduled amortization of loans and mortgage-backed securities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

The primary investing activity of the Bank has traditionally been the origination of one- to four-family mortgage loans and consumer loans, but in recent years the Bank has increased significantly its originations of other types of real estate loans and commercial business loans. Between December 31, 2003 and 2002, one- to four-family mortgages (excluding those held for sale) increased $4.8 million (11.6%) while loans to commercial borrowers increased $18.2 million (46.7%). Deposits, FHLB borrowings, and principal repayments on loans and mortgage-backed securities were the primary means for funding these activities.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. The Bank's sources of funds include deposits, principal and interest payments from loans and investments, and FHLB advances. During 2003 and 2002, the Company used its sources of funds primarily to fund new loans and to pay maturing certificates and other deposit withdrawals. At December 31, 2003, the Bank had loan commitments (excluding loans in process), including unused portions of commercial business lines of credit, of $11.3 million.

At December 31, 2003, the Bank had $40,000 of net unrealized losses on investment securities classified as available for sale, which represented 0.4% of the amortized cost ($11.3 million) of the securities. This represented a decline of $251,000 compared with $211,000 of unrealized gains at December 31, 2002, primarily due to changes in market demand. Movements in market interest rates will continue to affect the unrealized gains and losses in these securities. However, assuming that the securities are held to their individual dates of maturity, even in periods of increasing market interest rates, as the securities approach their dates of maturity, any unrealized gains or losses will begin to decrease and eventually be eliminated.

At December 31, 2003, certificates of deposit amounted to $37.2 million, or 26.8% of the Bank's total deposits, including $25.1 million scheduled to mature by December 31, 2004. Historically, the Bank has been able to retain a significant amount of its deposits as they mature. Management believes it has adequate resources to fund all loan commitments with deposits and, as needed, FHLB advances and sale of mortgage loans and that it can adjust the offering rates of certificates of deposits to retain deposits in changing interest rate environments. In addition, the Bank has available a line of credit with the FHLB generally equal to 25% of the Bank's total assets, or approximately $40.7 million at December 31, 2003, of which $31.5 million was unused.

The Bank is required to maintain specific amounts of capital pursuant to OTS requirements. As of December 31, 2003, Alaska Pacific was in compliance with all regulatory capital requirements that were effective as of this date with tangible, core, and risk-based capital ratios of 8.92%, 8.92% and 13.95%, respectively. For further information, see Note 2 of Notes to Consolidated Financial Statements.

Recent Accounting Pronouncements

Significant recent Statements of Financial Accounting Standards ("SFAS"), Financial Accounting Standards Board Interpretations ("FIN"), and an Emerging Issues Task Force ("EITF") consensus and the impact of their adoption are described below.

SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities,* issued in June 2002, addresses financial accounting and reporting costs associated with exit or disposal activities. The statement is effective beginning in 2003

SFAS 147, *Acquisitions of Certain Financial Institutions – an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9,* issued in October 2002, discontinues specialized guidance in accounting for acquisitions of banks and thrift institutions. The statement was effective beginning in October 2002

SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123,* issued in December 2002, provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The statement also requires certain disclosures in interim as well as annual financial statements. The statement is effective beginning in 2002.

FIN 46-R, *Consolidation of Variable Interest Entities,* issued in January 2003, provides guidance on the decision to consolidate certain "variable interest entities" in consolidated financial statements.

SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* issued in April 2003, clarifies when a contract meets the characteristic of a derivative, clarifies when a derivative contains a financing component and amends certain other existing pronouncements. The amendment is effective for contracts entered into or modified after September 30, 2003.

SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* issued in May 2003, requires the classification as a liability of any financial instrument with a mandatory redemption feature, an obligation to repurchase equity shares, or a conditional obligation based on the issuance of a variable number of its equity shares. The Company does not have any preferred shares or other financial instruments with a mandatory redemption feature. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective in the third quarter of 2003.

EITF 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* requires certain quantitative and qualitative disclosures for debt and marketable equity securities, classified as available-for-sale or held-to-maturity under SFAS 115 and SFAS 124, that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The consensus is effective in 2003. The Company has included the required disclosures in the consolidated financial statements.

Management believes that these new accounting standards will not have a significant impact on the Company's financial position, results of operations, or liquidity.

MOSS-ADAMS LLP
CERTIFIED PUBLIC ACCOUNTANTS

601 West Riverside, Suite 1800
Spokane, WA 99201-0663

Phone 509.747.2600
Toll Free 1.800.888.4065
FAX 509.624.5129
www.mossadams.com

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Alaska Pacific Bancshares, Inc.

We have audited the accompanying consolidated balance sheet of Alaska Pacific Bancshares, Inc. and Subsidiary (the Company) as of December 31, 2003, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The consolidated financial statements of the Company as of December 31, 2002, were audited by other auditors whose report dated February 14, 2003, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 2003 financial statements referred to above present fairly, in all material respects, the financial position of Alaska Pacific Bancshares, Inc. and Subsidiary as of December 31, 2003, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Spokane, Washington
February 6, 2004

Alaska Pacific Bancshares, Inc. and Subsidiary

Consolidated Balance Sheets

(dollars in thousands) December 31,			2003	2002
Assets				
Cash and due from banks			$ 6,127	$ 6,758
Interest-earning deposits in banks			12,999	21,471
Total cash and cash equivalents			19,126	28,229
Investment securities available for sale, at fair value (amortized cost: 2003 - $11,332; 2002 - $7,865)			11,292	8,076
Federal Home Loan Bank stock			1,732	1,649
Loans held for sale			2,938	4,590
Loans			125,282	107,274
Less allowance for loan losses			1,159	1,152
Loans, net			124,123	106,122
Accrued interest receivable			576	579
Premises and equipment (including building held for sale - $1,366 at December 31, 2002)			2,095	3,088
Repossessed assets			303	189
Other assets			2,374	1,817
Total Assets			$164,559	$154,339
Liabilities and Shareholders' Equity				
Deposits:				
Noninterest-bearing demand			$ 20,043	$ 18,094
Interest-bearing demand			32,220	31,044
Money market			24,973	21,999
Savings			24,225	22,790
Certificates of deposit			37,151	38,754
Total deposits			138,612	132,681
Federal Home Loan Bank advances			9,219	5,000
Advance payments by borrowers for taxes and insurance			686	754
Accounts payable and accrued expenses			292	425
Accrued interest payable			227	282
Other liabilities			266	230
Total liabilities			149,302	139,372
Commitments and contingencies (Notes 12 and 14)				
Shareholders' Equity:				
	December 31,			
Common stock ($0.01 par value):	2003	2002		
Authorized shares	20,000,000	20,000,000		
Issued	655,415	655,415		
Outstanding	626,132	623,132	7	7
Additional paid-in capital			5,857	5,814
Treasury stock	(29,283)	(32,283)	(362)	(400)
Unearned ESOP shares	(23,252)	(28,789)	(233)	(288)
Unvested shares in stock award plan	(8,300)	(13,544)	(80)	(131)
Retained earnings			10,092	9,754
Accumulated other comprehensive income			(24)	211
Total shareholders' equity			15,257	14,967
Total Liabilities and Shareholders' Equity			$164,559	$154,339

See notes to consolidated financial statements.

Alaska Pacific Bancshares, Inc. and Subsidiary

Consolidated Statements of Income

(in thousands, except per share) Year ended December 31,	2003	2002
Interest Income		
Loans	$7,684	$8,477
Investment securities	712	667
Interest-earning deposits in banks	232	171
Total interest income	8,628	9,315
Interest Expense		
Deposits	1,465	2,115
Federal Home Loan Bank advances	456	338
Total interest expense	1,921	2,453
Net Interest Income	6,707	6,862
Provision for loan losses	195	370
Net interest income after provision for loan losses	6,512	6,492
Noninterest Income		
Mortgage servicing income	179	189
Service charges on deposit accounts	660	562
Other service charges and fees	205	192
Gain on sale of mortgage loans	344	329
Total noninterest income	1,388	1,272
Noninterest Expense		
Compensation and benefits	3,736	3,429
Occupancy and equipment	1,385	1,343
Data processing	353	350
Professional and consulting fees	255	249
Marketing and public relations	226	181
Real estate owned expense, net	41	98
Loss on sale of building	85	-
Other	981	929
Total noninterest expense	7,062	6,579
Income before income tax	838	1,185
Provision for income tax (benefit)	335	(592)
Net Income	$ 503	$1,777
Net income per share:		
Basic	$0.86	$3.10
Diluted	0.81	2.98

See notes to consolidated financial statements.

Alaska Pacific Bancshares, Inc. and Subsidiary

Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income

(in thousands)	Common Stock	Additional Paid-In Capital	Treasury Stock	Unearned ESOP Shares	Unvested Shares in Stock Award Plan	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Share-holders' Equity
Balance, January 1, 2002	$ 7	$ 5,791	$(400)	$ (346)	$(183)	$8,116	$ 6	$ 12,991
Net income						1,777		1,777
Other comprehensive income:								
Change in net unrealized gains and losses on securities available for sale (net of income tax of $137)							205	205
Comprehensive income								1,982
ESOP shares earned		23		58				81
Accrued vesting of restricted stock					52			52
Cash dividends ($.23 per share)						(139)		(139)
Balance, December 31, 2002	7	5,814	(400)	(288)	(131)	9,754	211	14,967
Net income						503		503
Other comprehensive income:								
Change in net unrealized gains and losses on securities available for sale (net of income tax benefit of $157)							(235)	(235)
Comprehensive income								268
Exercise of stock options		(8)	38					30
ESOP shares earned		51		55				106
Accrued vesting of restricted stock					51			51
Cash dividends ($.27 per share)						(165)		(165)
Balance, December 31, 2003	$ 7	$5,857	$(362)	$(233)	$ (80)	$10,092	$ (24)	$15,257

See notes to consolidated financial statements.

Alaska Pacific Bancshares, Inc. and Subsidiary

Consolidated Statements of Cash Flows

(in thousands) Year ended December 31,	2003	2002
Operating Activities		
Net income	$ 503	$1,777
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	195	370
Depreciation and amortization	361	420
Deferred income tax expense (benefit)	335	(592)
Gain on sale of mortgage loans	(344)	(329)
Federal Home Loan Bank stock dividends	(83)	(96)
Amortization of fees, discounts, and premiums, net	(213)	(96)
ESOP expense	106	81
Stock award expense	51	52
Loss on sale of repossessed assets	13	8
Loss on sale of building	85	-
Cash provided by changes in operating assets and liabilities:		
Accrued interest receivable	3	89
Other assets	(877)	366
Advance payments by borrowers for taxes and insurance	(68)	(151)
Accrued interest payable	(55)	(327)
Accounts payable and accrued expenses	(133)	(1)
Other liabilities	36	(102)
Net cash provided by (used in) operating activities	(85)	1,469
Investing Activities		
Purchase of investment securities available for sale	(10,316)	-
Maturities and principal repayments of investment securities available for sale	6,759	4,449
Loan originations, net of principal repayments	(46,257)	(25,025)
Proceeds from sale of mortgage loans	30,111	25,501
Purchase of premises and equipment	(750)	(399)
Proceeds from sale of repossessed assets	123	115
Proceeds from sale of building	1,297	-
Net cash provided by (used in) investing activities	(19,033)	4,641
Financing Activities		
Cash dividends paid	(165)	(139)
Net increase (decrease) in Federal Home Loan Bank advances	4,219	(8,000)
Net increase in demand and savings deposits	7,534	9,598
Net decrease in certificates of deposit	(1,603)	(3,226)
Proceeds from exercise of stock options	30	-
Net cash provided by (used in) financing activities	(9,103)	(1,767)
Increase (decrease) in cash and cash equivalents	(9,103)	4,343
Cash and cash equivalents at beginning of year	28,229	23,886
Cash and cash equivalents at end of year	$19,126	$28,229
Supplemental information:		
Cash paid for interest	$ 1,976	$ 2,780
Loans repossessed and transferred to repossessed assets	824	146
Sale of repossessed assets financed by bank	574	-
Net change in unrealized loss on securities available for sale	(235)	205

See notes to consolidated financial statements.

Note 1 – Summary of Significant Accounting Policies

General: The accompanying consolidated financial statements include the accounts of Alaska Pacific Bancshares, Inc. (the "Holding Company") and its wholly owned subsidiary, Alaska Pacific Bank (the "Bank"). The Holding Company and the Bank are collectively referred to as the "Company." All significant intercompany transactions have been eliminated in consolidation.

The Holding Company was formed in 1999 when the Bank converted from a federally chartered mutual savings bank to a federally chartered stock savings bank, issuing 655,415 shares in a subscription and community offering. Concurrent with the conversion, the Bank changed its name from Alaska Federal Savings Bank to Alaska Pacific Bank.

The Bank provides a range of financial services to individuals and small businesses in Southeast Alaska. The Bank's financial services include accepting deposits from the general public and making residential and commercial real estate loans, consumer loans, and commercial loans. The Bank also originates, sells, and services residential mortgage loans under several federal and state mortgage-lending programs.

Investment Securities: Securities available for sale, including mortgage-backed and related securities, are carried at fair value with unrealized gains and losses excluded from earnings and reported in a separate component of equity. Any security that management determines may not be held to maturity is classified as available for sale at the time the security is acquired. Any gains and losses realized on the sale of these securities are based on the specific identification method and included in earnings.

Purchase discounts and premiums on investment securities are amortized using the level yield method.

Loans: Loans are reported at the principal amount outstanding, adjusted for net deferred loan fees and costs and other unamortized premiums or discounts.

Interest is accrued as earned unless management doubts the collectibility of the loan or the unpaid interest. Interest accrual is generally discontinued and loans are transferred to nonaccrual status when they become 90 days past due or earlier if the loan is impaired and collection is considered doubtful. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Income from nonaccrual loans is recorded only when interest payments are received.

Loans or portions of loans are charged off against the allowance for loan losses when considered uncollectible. Prior to charging a loan off, a loss allowance may be recognized on impaired loans for an estimated possible loss.

Loan origination fees and direct loan origination costs are deferred and recognized as an adjustment to interest income over the contractual life of the loan using the level yield method. When loans are sold, the related net unamortized loan fees and costs are included in the determination of the gain on sale of loans.

Loans Held for Sale: Loans held for sale consist primarily of residential mortgage loans and are individually valued at the lower of cost or market. Loans are recorded as sold when the loan documents are sent to the investor.

Allowance for Loan Losses: The allowance for loan losses is maintained at a level believed to be sufficient to absorb losses probable and inherent in the loan portfolio. Management's determination of the adequacy of the allowance is based on a number of factors, including the level of nonperforming loans, loan loss experience, collateral values, a review of the credit quality of the loan portfolio, and current economic conditions. Loans are categorized as either pass-graded or problem-graded based on periodic reviews of the loan portfolio. The allowance is evaluated quarterly based on an estimated range of probable loss comprised of two elements:

> *General component:* The general allowance component is calculated by loan category as a range of estimated loss by applying various loss factors to pass-graded outstanding loans. The loss factors are based primarily on industry loss statistics, adjusted for the Bank's historical loss experience and other significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date.
>
> *Specific component:* The specific allowance component is established in cases where management has identified conditions or circumstances related to a problem-graded loan that management believes indicate a probable loss. A range of estimated loss is established for each such loan.
>
> Loan impairment is measured in accordance with Statement of Financial Accounting Standards ("SFAS") No. 114, Accounting by Creditors for Impairment of a Loan and SFAS No. 118, Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures. Under these standards, loans are deemed to be impaired when management determines that it is probable that all amounts due under the contractual terms of the loan agreements will not be collectible in accordance with the original loan agreement. All problem-graded loans are evaluated for impairment. Impairment is measured by comparing the fair value of the collateral or present value of future cash flows to the recorded investment in the loan.

Mortgage Servicing Rights: Mortgage servicing rights are stated at amortized cost. Cost is amortized in proportion to, and over the period of, future expected net servicing income. Mortgage servicing rights are assessed for impairment based on the fair value of those rights and any impairment is recognized through a valuation allowance. In assessing impairment, the mortgage servicing rights are stratified based on the nature and risk characteristics, including coupon rates, of the underlying loans, which at December 31, 2003 and 2002, consisted primarily of one- to four-family residential mortgage loans.

Premises and Equipment: Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed on the straight-line method over the estimated useful lives of the assets: 20 to 50 years for buildings, five to 10 years for leasehold improvements, and three to 10 years for furniture and equipment. Expenditures for improvements and major renewals are capitalized and ordinary maintenance and repairs are charged to operations as incurred.

Long-lived assets are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In performing the review for recoverability, estimated future cash flows expected to result from the use of the asset and its eventual disposition are compared with the carrying value, and a direct writedown is recorded for the amount of impairment, if any.

Repossessed Assets: Real estate or other collateral acquired in satisfaction of a loan is initially recorded in repossessed assets at the lower of cost or estimated fair value less estimated selling costs, with any difference from the loan balance charged to the allowance for loan losses. Subsequent changes in estimated fair value result in writing down the properties, directly or through valuation accounts. Such writedowns and gains and losses on disposal, as well as operating income and costs incurred during the period of ownership, are recognized currently in noninterest expense.

Federal Home Loan Bank Stock: The Bank's investment in Federal Home Loan Bank of Seattle ("FHLB") stock is carried at cost because there is no active market for the stock. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specified percentages of its outstanding mortgages, total assets or FHLB advances. At December 31, 2003, the Bank's minimum investment requirement was approximately $517,000. The Bank may request redemption at par value on any stock in excess of the amount the Bank is required to hold. Stock redemptions are granted at the discretion of the FHLB.

Advertising Expense: Advertising costs are expensed as incurred. Advertising expense was $135,000 and $112,000 for the years ended December 31, 2003 and 2002, respectively.

Income Tax: The Company accounts for income tax using the asset and liability method. The asset and liability method recognizes the amount of tax payable at the date of the financial statements as a result of all events that have been recognized in the financial statements, as measured by the provisions of current enacted tax laws and rates. Net deferred tax assets are evaluated and reduced through a valuation allowance to the extent that it is more likely than not that such assets will not be fully recovered in the future.

Treasury Stock: Treasury stock is accounted for on the basis of average cost, or $12.375 per share at December 31, 2003 and 2002.

Employee Stock Ownership Plan: Compensation expense under the Company's Employee Stock Ownership Plan ("ESOP") is based upon the number of shares allocated to employees each year times the average share price for the year. Expense is reduced by the amount of dividends paid on unallocated shares. In computing earnings per share, shares outstanding are reduced by shares held by the ESOP that have not yet been allocated to employees.

Stock Option Plan: We have adopted SFAS No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123. This statement amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, that Statement requires prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. We have elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure as required by SFAS 148.

For purposes of pro forma disclosures, the estimated fair value of options at the time they are granted is amortized to expense over the options' vesting period of five years. The fair value of options granted, primarily in 2000, was estimated using the Black-Scholes option pricing model, assuming a risk-free interest rate of 6.17%, a dividend yield of 2%, a stock price volatility factor of 0.19, and a weighted-average expected life of seven years. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to its stock option plan.

Year ended December 31	2003	2002
Net income, as reported	$503,000	$1,777,000
Total stock option employee compensation expense determined under fair value based method, net of tax effect	(23,000)	(22,000)
Pro forma net income	$480,000	$1,755,000
Earnings per share:		
Basic – as reported	$0.86	$3.10
Basic – pro forma	0.82	3.07
Diluted – as reported	0.81	2.98
Diluted – pro forma	0.77	2.94

Statement of Cash Flows: The statement of cash flows has been prepared using the "indirect" method for presenting cash flows from operating activities. For purposes of this statement, cash and cash equivalents include cash and due from banks and interest-bearing deposits with banks.

Segment Reporting: The Company has identified a single segment at the entity-wide level used by senior management to make operating decisions.

Recent Accounting Pronouncements: Significant recent Statements of Financial Accounting Standards, Financial Accounting Standards Board Interpretations ("FIN"), and an Emerging Issues Task Force ("EITF") consensus and the impact of their adoption are described below.

SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities,* issued in June 2002, addresses financial accounting and reporting costs associated with exit or disposal activities. The statement is effective beginning in 2003

SFAS 147, *Acquisitions of Certain Financial Institutions – an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9,* issued in October 2002, discontinues specialized guidance in accounting for acquisitions of banks and thrift institutions. The statement was effective beginning in October 2002

SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure – an amendment of FASB Statement No. 123,* issued in December 2002, provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The statement also requires certain disclosures in interim as well as annual financial statements. The statement is effective beginning in 2002.

FIN 46-$, *Consolidation of Variable Interest Entities,* issued in January 2003, provides guidance on the decision to consolidate certain "variable interest entities" in consolidated financial statements.

SFAS No. *149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities,* issued in April 2003, clarifies when a contract meets the characteristic of a derivative, clarifies when a derivative contains a financing component and amends certain other existing pronouncements. The amendment is effective for contracts entered into or modified after September 30, 2003.

SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* issued in May 2003, requires the classification as a liability of any financial instrument with a mandatory redemption feature, an obligation to repurchase equity shares, or a conditional obligation based on the issuance of a variable number of its equity shares. The Company does not have any preferred shares or other financial instruments with a mandatory redemption feature. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective in the third quarter of 2003.

EITF 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* requires certain quantitative and qualitative disclosures for debt and marketable equity securities, classified as available-for-sale or held-to-maturity under SFAS 115 and SFAS 124, that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The consensus is effective in 2003. The Company has included the required disclosures in the consolidated financial statements.

Management believes that these new accounting standards will not have a significant impact on the Company's financial position, results of operations, or liquidity.

Fair Value of Financial Instruments: The fair value of cash and cash equivalents and accrued interest receivable is estimated to be equal to the carrying value, due to their short-term nature. The fair value of investment securities is based upon estimated market prices obtained from independent safekeeping agents. The fair value of FHLB stock is considered to be equal to its carrying value, since it may be redeemed at that value. The fair value of loans is estimated using present value methods which discount the estimated cash flows, including prepayments as well as contractual principal and interest, using current interest rates appropriate for the type and maturity of the loans.

For demand and savings deposits and accrued interest payable, fair value is considered to be carrying value. The fair values of fixed-rate certificates of deposit and FHLB advances are estimated using present value methods and current offering rates for such deposits and advances.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Material estimates that are particularly susceptible to change in the near term relate to the determination of the allowance for loan losses, deferred income taxes, and useful lives for depreciation of premises and equipment. Actual results could differ from these estimates.

Note 2 – Regulatory Capital Requirements and Restrictions

The Bank is restricted on the amount of dividends it may pay to the Company. It is generally limited to the net income of the current fiscal year and that of the two previous fiscal years, less dividends already paid during those periods. At December 31, 2003, the Bank's retained earnings available for dividends to the Company were approximately $2,107,000. However, payment of dividends may be further restricted by the Bank's regulatory agency if such payment would reduce the Bank's capital ratios below required minimums or would otherwise be considered to adversely affect the safety and soundness of the institution.

The Bank is subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action ("PCA"), the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures have been established by regulation to ensure capital adequacy and require the Bank to maintain minimum capital amounts and ratios (set forth in the following table). The Bank's primary regulatory agency, the Office of Thrift Supervision, requires that the Bank maintain minimum amounts and ratios of tangible capital (as defined in the regulations) of 1.5%, core capital (as defined) of 4%, and total risk-based capital (as defined) of 8%. The Bank is also subject to PCA capital requirement regulations set forth by the Federal Deposit Insurance Corporation ("FDIC"). The FDIC requires the Bank to maintain minimum amounts and ratios of total and Tier I capital (as defined) to risk-weighted assets (as defined). Management believes that, as of December 31, 2003 and 2002, the Bank meets all capital adequacy requirements to which it is subject. The Bank was categorized as "well capitalized" in the most recent notification by the Office of Thrift Supervision. There have been no events or conditions since that notification that management believes would change the Bank's capital category.

Following is a summary of the Bank's capital ratios:

			Minimum Capital Required			
(dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Categorized as "Well Capitalized" Under PCA Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2003:						
Tangible capital (to total assets)	$14,513	8.92%	$2,440	1.50%	N/A	N/A
Core capital (to total assets)	14,513	8.92	6,508	4.00	$8,134	5.00%
Total risk-based capital (to risk weighted assets)	15,672	13.95	8,988	8.00	11,235	10.00
Tier I risk-based capital (to risk weighted assets)	14,513	12.92	N/A	N/A	6,741	6.00
December 31, 2002:						
Tangible capital (to total assets)	$14,230	9.36%	$2,280	1.50%	N/A	N/A
Core capital (to total assets)	14,230	9.36	6,081	4.00	$7,601	5.00%
Total risk-based capital (to risk weighted assets)	15,382	15.68	7,846	8.00	9,808	10.00
Tier I risk-based capital (to risk weighted assets)	14,230	14.51	N/A	N/A	5,885	6.00

Note 3 – Investment Securities Available for Sale

Amortized cost and fair values of investment securities available for sale, including mortgage-backed securities, are summarized as follows:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2003:				
Mortgage-backed securities:				
FNMA	$8,089	$ 1	$ (172)	$7,918
FHLMC	1,130	-	(66)	1,064
GNMA	1,958	209	(15)	2,152
U.S. agencies and corporations:				
SBA pools	155	3	-	158
Total	$11,332	$213	$(253)	$11,292
December 31, 2002:				
Mortgage-backed securities:				
FNMA	$1,330	$ 2	$ (45)	$1,287
FHLMC	1,517	-	(86)	1,431
GNMA	4,733	358	(22)	5,069
U.S. agencies and corporations:				
SBA pools	285	4	-	289
Total	$7,865	$364	$(153)	$8,076

Impaired securities (those with unrealized losses) at December 31, 2003 are summarized as follows:

	Impaired less than 12 months		Impaired 12 months or more		Total	
(in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities:						
FNMA	$7,009	$137	$ 865	$ 35	$7,874	$172
FHLMC	-	-	1,064	66	1,064	66
GNMA	-	-	255	15	255	15
Total	$7,009	$137	$2,184	$116	$9,193	$253

All securities with unrealized losses at December 31, 2003 were mortgage-backed securities issued by the U.S. government and agencies; collectibility of principal and interest is considered to be reasonably assured. The fair values of individual securities fluctuate significantly with interest rates and with market demand for securities with specific structures and characteristics. Management does not consider these unrealized losses to be other than temporary.

No securities were designated as held to maturity at December 31, 2003 or 2002.

All investment securities at December 31, 2003 have final contractual maturities of more than ten years. Actual maturities may vary due to prepayment of the underlying loans.

At December 31, 2003, investment securities with amortized cost of $7,899,000 and market value of $7,960,000 were pledged to secure public funds deposited with the Bank.

There were no sales of securities during 2003 or 2002. The Bank does not have a securities trading portfolio.

Note 4 – Loans

Loans are summarized as follows:

(in thousands) December 31,	2003	2002
Real estate:		
Permanent:		
One- to four-family	$46,219	$41,419
Multifamily	1,108	2,209
Commercial nonresidential	34,222	26,075
Land	3,425	5,120
Construction:		
One- to four-family	2,330	3,643
Commercial nonresidential	-	52
Commercial business	23,050	12,975
Consumer:		
Home equity	9,361	8,912
Boat	4,326	5,249

Loans are net of deferred loan fees and other discounts amounting to $552,000 and $493,000 at December 31, 2003 and 2002, respectively.

Loans include overdrawn balances of deposit accounts of $29,000 and $38,000 at December 31, 2003 and 2002, respectively.

Interest income from tax-exempt loans was $4,000 and $68,000 in 2003 and 2002, respectively.

Real estate loans are secured primarily by properties located in Southeast Alaska. Commercial real estate loans are generally secured by warehouse, retail, and other improved commercial properties. Commercial business loans are generally secured by equipment, inventory, accounts receivable, or other business assets.

Impaired loans are summarized as follows:

(in thousands) Year ended December 31,	2003	2002
Impaired loans at end of year	$331	$766
Impaired loans at end of year for which allowances has been determined	331	766
Amount of allowances at end of year	136	329
Average impaired loans	610	456
Interest income recognized on impaired loans	2	12

Nonaccrual loans were $313,000 and $1,777,000 at December 31, 2003 and 2002, respectively. For the year ended December 31, 2003, approximately $18,000 of interest would have been recorded if these loans would have been current according to their original terms and had been outstanding throughout the year; no interest income on these loans was included in income for the year.

Mortgage Loan Servicing: The Bank services residential and other real estate loans for Alaska Housing Finance Corporation ("AHFC"), U.S. Government agencies, and institutional and private investors totaling $83,828,000 and $84,254,000 as of December 31, 2003 and 2002, respectively. These loans are the assets of the investors and, accordingly, are not included in the accompanying balance sheets. Related servicing income, net of amortization of mortgage servicing rights, amounted to $179,000 and $189,000 for 2003 and 2002, respectively.

The amortized cost of mortgage servicing rights, which approximates fair value, is $653,000 and $534,000 at December 31, 2003 and 2002, respectively. The amount of servicing assets recognized during 2003 was $208,000 and amortization was $89,000 for the year. The amount of servicing assets recognized during 2002 was $176,000 and amortization was $60,000 for the year. Management has determined that a valuation allowance for impairment is not required at December 31, 2003 or 2002.

Included in loans serviced for others at December 31, 2003 are 6 loans with current balances totaling $376,000 for which the Bank is subservicer under agreements with AHFC. Of these, five loans totaling $372,000 are owned by the Government National Mortgage Association ("GNMA") and one loan for $4,000 is owned by the Federal National Mortgage Association ("FNMA").

Related Party Loans: In the ordinary course of business, the Bank makes loans to executive officers and directors of the Bank and to their affiliates. Such loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions. The aggregate dollar amount of these loans was $1,642,000 and $2,749,000 at December 31, 2003 and 2002, respectively. During the year ended December 31, 2003 and 2002, new loans of this type were $69,000 and $792,000, respectively, and repayments were $1,176,000 and $1,672,000, respectively.

Note 5 – Allowance for Loan Losses

Following is an analysis of the changes in the allowance for loan losses:

(in thousands) Year ended December 31,	2003	2002
Balance at beginning of year	$1,152	$ 939
Provision for loan losses	195	370
Loans charged off	(207)	(164)
Recoveries	19	7
Balance at end of year	$1,159	$1,152

Note 6 – Premises and Equipment

Following is a summary of premises and equipment:

(in thousands) December 31,	2003	2002
Land	$ 424	$ 676
Buildings	1,941	4,154
Leasehold improvements	1,894	1,541
Furniture, fixtures and equipment	2,309	2,116
	6,568	8,487
Less accumulated depreciation	(4,473)	(5,399)
	$2,095	$3,088

Depreciation and amortization expense for the years ended December 31, 2003 and 2002 amounted to $361,000 and $420,000, respectively.

In February 2003, the Bank sold its office building in Ketchikan, Alaska for $1,400,000 in cash. A loss, including transaction and related costs, of $85,000 was recorded in the first quarter of 2003. The Bank has leased back a portion of the premises for continued use as a banking office. Future minimum lease payments amount to approximately $56,000 per year for five years.

Note 7 – Deposits

Deposits in excess of $100,000 are not federally insured. Certificates of deposit exceeding $100,000 at December 31, 2003 and 2002 were $8,133,000 and $11,849,000, respectively, and the uninsured excess over $100,000 amounted to $2,933,000 and $6,149,000, respectively.

The scheduled maturities of certificates of deposit as of December 31, 2003, are as follows:

(in thousands) Year ending December 31,	
2004	$25,087
2005	3,505
2006	5,476
2007	679
2008 and thereafter	2,404
	$37,151

Interest expense on deposits consists of the following:

(in thousands) Year ended December 31,	2003	2002
Interest-bearing demand	$ 143	$ 227
Money market	241	359
Savings	181	309
Certificates of deposit	900	1,220
	$1,465	$2,115

The weighted averages interest rates paid on deposits are as follows:

Year ended December 31,	2003	2002
Interest-bearing demand	0.47%	0.78%
Money market	1.04	1.66
Savings	0.79	1.46
Certificates of deposit	2.39	3.04

Deposits from the Company's executive officers, directors, and their related companies were $2,594,000 and $1,764,000 at December 31, 2003 and 2002, respectively.

Note 8 – Federal Home Loan Bank Advances

FHLB advances consist of the following:

(dollars in thousands) December 31,	2003	2002
Five-year amortizing advance, final maturity in 2008, 3.03%	$2,471	$ -
Seven-year amortizing advance, final maturity in 2010, 3.62%	1,748	-
Putable advance, maturing in 2009, putable earlier at discretion of FHLB, 6.13%	5,000	5,000
	$9,219	$5,000

FHLB advances at December 31, 2003 have scheduled maturities as follows:

(in thousands) Year ending December 31,	
2004	$886
2005	886
2006	886
2007	886
2008	356
Thereafter	5,319
Total	$9,219

The average balance of FHLB advances outstanding during 2003 and 2002 was $9,457,000 and $5,485,000, respectively. The maximum amount of advances outstanding at any month end during 2003 and 2002 was $10,000,000 and $13,000,000, respectively. Under a blanket pledge agreement, all funds on deposit at FHLB, as well as all unencumbered qualifying loans and investment securities, are available to collateralize FHLB advances.

The Bank has available a line of credit with the FHLB generally equal to 25% of the Bank's total assets, or approximately $40.7 million at December 31, 2003, of which $31.5 million was unused.

Note 9 – Retirement Plans

The Bank has a salary deferral 401(k) plan. Employees who are at least 18 years of age and have completed three months of service are eligible to participate in the plan. Employees may contribute on a pretax basis up to 17% of their annual salary up to a maximum limit under the law. The Bank matches 75% of the first $2,667 of employee contribution. For the years ended December 31, 2003 and 2002, the Bank contributed $62,000 and $67,000, respectively, to the plan, including administrative expenses.

The Company has an Employee Stock Ownership Plan ("ESOP") established in connection with the conversion to stock ownership. Eight percent of the shares issued in the conversion, or 52,433 shares, were purchased by the ESOP in exchange for a note payable to the Holding Company. The shares are allocated to employees over a ten-year period in proportion to the principal and interest paid on the note at the end of each year. All employees who have completed one year's service automatically participate in the plan, and each year's allocation is distributed in proportion to total compensation of employees. Employees are vested in the plan over a seven-year period. Dividends paid on allocated shares are credited to employee's accounts, but dividends on unallocated shares are used to reduce the expense of the plan. At December 31, 2003 and 2002, 29,181 and 23,644 shares, respectively, were allocated to employees. The Company's expense for the plan, including administrative expenses, amounted to $108,000 and $82,000 for the years ended December 31, 2003 and 2002, respectively. Unallocated shares had a market value of $465,000 and $398,000 at December 31, 2003 and 2002, respectively.

Note 10 – Stock-Based Compensation

Stock Option Plan: In 2000, the shareholders approved the 2000 Stock Option Plan, providing for the granting of options to directors and officers on up to 65,542 shares of the Company's stock. Options on 65,542 shares were granted in 2000, with an exercise price equal to the market price of the stock at the date of grant, or $9.75. Options on 3,400 shares were granted in 2003, replacing forfeitures, with an exercise price of $17.50. Options become exercisable in five equal annual installments commencing one year after the date of grant, and unexercised options expire ten years after the date of grant.

In 2003, the shareholders approved the 2003 Stock Option Plan, providing for the granting of options on up to 32,000 shares. No options have been granted under the 2003 plan.

Following is a summary of the changes in stock options:

(in thousands) Year ended December 31,	2003		2002	
	Number of Options	Exercise Price	Number of Options	Exercise Price
Stock options outstanding at beginning of year	62,142	$9.75	64,542	$9.75
Granted	3,400	17.50	-	-
Exercised	(3,000)	9.75	-	-
Forfeited	-	9.75	(2,400)	9.75
Stock options outstanding at end of year	62,542	$9.75 - $17.50	62,142	$9.75
Options exercisable at end of year	36,324	$9.75	25,818	$9.75

Stock options outstanding at December 31, 2003 are summarized as follows:

December 31, 2003	Weighted-Average Exercise Price	Number Outstanding at End of Year	Weighted-Average Remaining Contractual Life (Years)	Number Exercisable
	$ 9.75	59,142	6.6	36,324
	17.50	3,400	9.2	-
Total	$10.17	62,542	6.7	36,324

Management Recognition Plan: During 2000, the shareholders approved the 2000 Management Recognition Plan, providing for the issuance of up to 26,217 shares of stock in the form of restricted stock awards. On July 20, 2000, 26,217 shares were granted with a total cost of $256,000, based on the market price of $9.75 per share. The shares vest in five equal annual installments commencing July 20, 2001. A total of 10,388 shares remained restricted at December 31, 2003. Compensation expense related to the plan was $54,000 and $57,000 for the years ended December 31, 2003 and 2002, respectively, including dividends on restricted shares.

Note 11 – Operating Leases

The Bank leases certain of its premises and equipment under noncancelable operating leases with terms in excess of one year. Future minimum lease payments under these leases at December 31, 2003, are summarized as follows:

(in thousands) Year ending December 31,	
2004	$ 478
2005	476
2006	449
2007	440
2008	374
2009 and thereafter	258
	$2,475

Rent expense was $489,000 and $422,000 for the years ended December 31, 2003 and 2002, respectively. Rental income on owned premises amounted to $17,000 and $72,000 for the years ended December 31, 2003 and 2002, respectively.

Note 12 – Income Tax

The provision for income tax consisted of the following:

(in thousands) Year ended December 31,	2003	2002
Taxes paid or currently payable	$ -	$ -
Change in deferred taxes	335	456
Adjustment of valuation allowance	-	(1,048)
Income tax expense (benefit)	$335	$ (592)

A reconciliation of taxes computed at federal statutory corporate tax rates (34% in 2003 and 2002) to tax expense, as shown in the accompanying statements of income and changes in shareholders' equity, is as follows:

(in thousands) Year ended December 31,	2003	2002
Income tax expense at statutory rate	$285	$ 403
Income tax effect of:		
Interest on municipal obligations	-	(23)
Effect of state income tax	52	-
Other	(2)	(76)
Reduction of valuation allowance for deferred taxes	-	(1,048)
Income tax expense (benefit)	$335	$ (592)
Effective tax rate	40%	(50%)

Deferred federal income tax is provided for the temporary differences between the tax basis and financial statement carrying amounts of assets and liabilities. Components of the Company's net deferred tax assets consisted of the following:

(in thousands) December 31,	2003	2002
Deferred tax assets:		
Net operating loss carryforward	$ 465	$ 596
Bad debt reserves	557	639
Property, plant and equipment	17	50
Accrued vacation and bonus	84	134
Other	55	25
Gross deferred tax assets	1,178	1,444
Deferred tax liabilities:		
Deferred loan fees, net	(51)	(38)
FHLB stock dividends	(540)	(507)
Other	(6)	(7)
Gross deferred tax liabilities	(597)	(552)
Net deferred tax assets	$ 581	$ 892

In August 1996, the Small Business Job Protection Act of 1996 ("the Act") was signed into law. Under the Act, the percentage of taxable income method of accounting for tax basis bad debts is no longer available effective for the years ending after December 31, 1995. As a result, the Bank is required to use the experience method of accounting for tax basis bad debts for 1998 and later years. In addition, the Act requires the recapture of post-1987 (the base year) additions to the tax bad debt reserves made pursuant to the percentage of taxable income method. The Bank is not subject to this recapture in 2003 or 2002, as its tax bad debt reserves do not exceed its base year reserve. As a result of the bad debt deductions, shareholders' equity as of December 31, 2003, includes accumulated earnings of approximately $1,759,000 for which federal income tax has not been provided. If, in the future, this portion of retained earnings is used for any purpose other than to absorb losses on loans or on property acquired through foreclosure, federal income tax may be imposed at then-applicable rates.

For federal income tax purposes, the Company had net operating loss carryforwards at December 31, 2003, which expire as follows:

(in thousands) Year ending December 31,	
2007	$ 653
2008	203
2010	81
2011	29
2017	28
2018	51
2019	206
2020	51
2021	24
2022	26
	$1,352

Note 13 – Commitments and Contingencies

Commitments: Commitments to extend credit, including lines of credit, total $11,318,000 and $4,101,000 at December 31, 2003 and 2002, respectively. Commitments to extend credit, generally at a variable interest rate, are arrangements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee by the customer. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates creditworthiness for commitments on an individual customer basis.

Undisbursed loan proceeds, primarily for real estate construction loans, total $1,640,000 and $2,114,000 at December 31, 2003 and 2002, respectively. These amounts are excluded from the balance of loans at year end.

At December 31, 2003, the Bank is committed to making future minimum payments of approximately $505,000 under contractual agreements for data processing and related services.

The Bank has deposits in other institutions in excess of $100,000 insured by the FDIC.

Concentrations: Approximately 75% of all loans in the Bank's portfolio are secured by real estate located in communities of Southeast Alaska.

Note 14 – Earnings per Share

Basic earnings per share ("EPS") is computed by dividing net income by the weighted-average number of common shares outstanding during the period less treasury stock, unvested stock awards under the Management Recognition Plan ("unvested stock awards"), and unallocated and not yet committed to be released Employee Stock Ownership Plan shares ("unearned ESOP shares"). Diluted EPS is calculated by dividing net income by the weighted-average number of common shares used to compute basic EPS plus the incremental amount of potential common stock from unvested stock awards and stock options, determined by the treasury stock method.

Year ended December 31,		2003			2002	
	Net Income	Average Shares	Earnings Per Share	Net Income	Average Shares	Earnings Per Share
Net income/average shares issued	$503,000	655,415		$1,777,000	655,415	
Treasury stock		(30,763)			(32,283)	
Unvested stock awards		(10,923)			(16,167)	
Unearned ESOP shares		(28,789)			(34,621)	
Basic EPS	503,000	584,940	$0.86	1,777,000	572,344	$3.10
Incremental shares under stock plans:						
Stock awards		5,345			4,965	
Stock options		29,960			19,636	
Diluted EPS	$503,000	620,245	$0.81	$1,777,000	596,945	$2.98

Note 15 – Fair Value of Financial Instruments

The following information is presented in accordance with the requirements of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments.* The estimated fair value amounts have been determined by the Bank using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Bank could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

(in thousands) December 31,	2003		2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial Assets				
Cash and cash equivalents	$ 19,126	$ 19,126	$ 28,229	$ 28,229
Investment securities available for sale	11,292	11,292	8,076	8,076
FHLB stock	1,732	1,732	1,649	1,649
Loans, net, including held for sale	127,061	126,903	110,712	113,675
Accrued interest receivable	576	576	579	579
Financial Liabilities				
Demand and savings deposits	101,461	101,461	93,927	93,927
Certificates of deposit	37,151	37,552	38,754	39,391
FHLB Advances	9,219	9,983	5,000	5,895
Accrued interest payable	227	227	282	282

The estimated fair value of loan commitments is zero at December 31, 2003 and 2002. Although management is not aware of any subsequent events that would significantly affect the estimated fair value amounts as of December 31, 2003, such amounts have not been comprehensively revalued since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Note 16 – Parent Company Financial Information

Summarized financial information for Alaska Pacific Bancshares, Inc. (parent company only) is presented below:

PARENT COMPANY CONDENSED BALANCE SHEET

(in thousands) December 31,	2003	2002
Assets		
Cash	$ 706	$ 452
Investment in subsidiary	14,549	14,515
Other assets	2	-
Total Assets	$15,257	$14,967
Liabilities and Shareholders' Equity		
Shareholders' equity	$15,257	$14,967
Total Liabilities and Shareholders' Equity	$15,257	$14,967

PARENT COMPANY CONDENSED INCOME STATEMENT

(in thousands) Year ended December 31,	2003	2002
Equity in earnings of subsidiary	$590	$1,859
Total income	590	1,859
Operating expenses	87	82
Income before income tax	503	1,777
Income tax	-	-
Net income	$503	$1,777

PARENT COMPANY CONDENSED STATEMENT OF CASH FLOWS

(in thousands) Year ended December 31,	2003	2002
Cash flows from operating activities:		
Net income	$503	$1,777
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings of subsidiary	(590)	(1,859)
Increase in other assets	(2)	-
Net cash used in operating activities	(89)	(82)
Cash flows from investing activities:		
Distributions received from subsidiary	508	405
Net cash provided by investing activities	508	405
Cash flows from financing activities:		
Cash dividends paid	(165)	(139)
Net cash used in financing activities	(165)	(139)
Net increase in cash	254	184
Cash at beginning of year	452	268
Cash at end of year	$706	$ 452

Form 10-KSB

A copy of the Form 10-KSB, including consolidated financial statements, as filed with the Securities and Exchange Commission, will be furnished without charge to stockholders as of the record date for voting at the annual meeting of shareholders upon written request to Roger K. White, Secretary, Alaska Pacific Bancshares, Inc., 2094 Jordan Avenue, Juneau, Alaska 99801.

Directors and Executive Officers

Scott C. Milner
President
Milner, Howard,
Mortensen PC, CPA's

Hugh N. Grant
Real estate
and retailing

Eric McDowell
President
McDowell Group, Inc.

William J. Schmitz
Partner
Schmitz & Buck

Avrum M. Gross
Retired Partner
Gross & Burke

Craig E. Dahl
President and Chief
Executive Officer
Alaska Pacific Bancshares,
Inc. and Alaska Pacific Bank

Roger Grummett
Chairman of the Board
Retired Partner
Shattuck & Grummett, Inc.

Marta Ryman
Director and former
Chairman
Shee Atika, Inc.

Deborah R. Marshall
CEO
McDunnah's Ltd.

Executive Officers

John E. Robertson
Senior Vice President and Chief Lending Officer of Alaska Pacific Bank

Craig E. Dahl
President and Chief Executive Officer of Alaska Pacific Bancshares, Inc. and Alaska Pacific Bank

Lisa Corrigan
Executive Vice President and Chief Operating Officer of Alaska Pacific Bancshares, Inc. and Alaska Pacific Bank

Roger K. White
Senior Vice President, Chief Financial Officer and Secretary of Alaska Pacific Bancshares, Inc. and Senior Vice President and Chief Financial Officer of Alaska Pacific Bank

Corporate Information

Corporate Headquarters
2094 Jordan Avenue
Juneau, AK 99801
907-789-4844

Independent Auditors
Moss Adams LLP
601 West Riverside
Suite 1800
Spokane, WA 99201

Stock Registrar and Transfer Agent
Computershare Trust Company, Inc.
350 Indiana St., Suite 350
Golden, CO 80401

Common Stock
Traded on the OTC Electronic Bulletin Board
under the symbol: AKPB

Special Counsel
Breyer & Associates PC
8180 Greensboro Drive
Suite 785
McLean, VA 22102

General Counsel
Baxter Bruce & Sullivan PC
P.O. Box 32819
Juneau, AK 99803

Annual Meeting of Stockholders
May 18, 2004
11:00 a.m.
Ray Renshaw Room
Aspen Hotel
1800 Shell Simmons Drive
Juneau, AK 99801